

VIRGINIA: IN THE CIRCUIT COURT FOR THE CITY OF PORTSMOUTH

**REPORT OF SPECIAL GRAND JURY ON ACTIVITIES REGARDING THE
FUNDING AND EXPENDITURES BY THE PORTSMOUTH PUBLIC SCHOOLS**

AUTHORITY OF THE SPECIAL GRAND JURY

By Order entered by the Circuit Court of the City of Portsmouth, Virginia on August 29, 2012, a Special Grand Jury was impaneled pursuant to §19.2-206(A)(iii) of the Code of Virginia, 1950, as amended to investigate and report to the Court on any condition that involves or tends to promote criminal activity as it pertains to the funding and expenditures of the Portsmouth Public Schools as provided in §19.2-191(2) of the Code.

By Order entered October 31, 2012, the Court appointed Lieutenant Larry Jacobs of the Portsmouth Police Department to assist the Special Grand Jury in its investigation, and Deputy Commonwealth's Attorney Mary Harris was designated as Grand Jury Coordinator and administrative assistant to the Special Grand Jury.

By Order entered November 21, 2012, the Court appointed Alan Ball as Special Investigator to provide investigative services to the Special Grand Jury. Pursuant to §19.2-206 of the Code of Virginia, 1950, as amended and the Orders of this Court, the Special Grand Jury conducted an investigation of the matters referred to it, and files this report as required under §19.2-213 of the Code of Virginia, 1950, as amended.

SUMMARY OF PROCEEDINGS

The Special Grand Jury convened on four separate occasions beginning on November 19, 2012 and ending on February 13, 2013. In addition to hearing testimony under oath, reviewing exhibits, reviewing statutes, and participating in deliberations, individual members devoted hours

to the review of documents obtained during the course of the investigation and transcripts of testimony. Special Investigator Alan Ball interviewed a number of people believed to have potentially relevant information and reported his findings to the panel. Documents were reviewed for relevance by the Special Investigator and Commonwealth's Attorney and were considered by the Special Grand Jury as necessary. The Special Grand Jury last heard testimony on January 16, 2013. The panel met to deliberate and consider its Report on February 13, 2012.

BACKGROUND

The Special Grand Jury undertook to investigate issues associated with the Funding and Expenditures of Portsmouth Public School Funds.

On or about April 24, 2012, Carol Swindell, the newly appointed Chief Financial Officer of the City of Portsmouth, Virginia, presented a briefing to the Portsmouth City Council identifying issues regarding the Portsmouth School Board's (hereinafter referred to as School Board) financial statements. During the period of time from Fiscal Year 2006-07 through Fiscal Year 2010-11, the School Board had accumulated large surpluses in the School Board's General Fund to the tune of over Fifty-Two Million Dollars (\$52,000,000.00). Much of these funds were transferred to School Construction Fund of the School without City Council approval. Questions regarding the legality of this practice in light of the Code of Virginia, 1950, as amended and the Portsmouth City Charter were raised.

Allegations concerning the surplus funds were widely reported in the local press. Citizens complained openly in council meeting. On numerous occasions, citizens met with the Commonwealth's Attorney demanding that an investigation be initiated against various members of the Portsmouth City Council, Portsmouth School Board and the Superintendent of Schools.

Citizens called for an investigation by the Virginia State Police and the Virginia Attorney General's Office.

Based on the timing of the School Board and Council elections in November 2012, the Commonwealth's Attorney chose not to launch a public investigation. Instead he sought the impanelling of this Special Grand Jury so as not to publicly malign those involved and thereby potentially influence the election prior to the completion of this investigation, the presumption of innocence being foremost.

APPLICABLE LAW

STATE LAW

Virginia Code Section 22.1-89 Management of Funds

Each school board shall manage and control the funds made available to the school board for public schools and may incur costs and expenses. If funds are appropriated to the school board by major classification as provided in section 22.1-94, no funds shall be expended by the school board except in accordance with such classification without the consent of the governing body appropriating the funds.

Virginia Code Section 22.1-91 Limitation on Expenditures; Penalty

No school board shall expend or contract to expend, in any fiscal year, any sum of money in excess of the funds available for school purposes for that fiscal year without the consent of the governing body or bodies appropriating funds to the school board. Any member of a school board or any division superintendent or other school officer violating, causing to be violated or voting to violate any provision of this section shall be guilty of malfeasance in office.

Virginia Code Section 22.1-94 Appropriations by county, city or town governing body for public schools

A governing body may make appropriations to a school board from the funds derived from local levies and from any other funds available, for operation, capital outlay and debt service in the public schools....The amount appropriated by the governing body for public schools shall relate to its total only or to such major classifications prescribed by the Board of Education pursuant to section 22.1-115.

Virginia Code Section 22.1-115 System of accounting; statements of funds available; classification of expenditures

...major classifications of expenditures of school funds: (i) instruction, (ii) administration, attendance and health, (iii) pupil transportation, (iv) operation and maintenance, (v) school food services and other noninstructional operations, (vi) facilities, (vii) debt and fund transfers, (viii) technology, and (ix) contingency reserves.

Virginia Code Section 22.1-100 Unexpended school and educational funds

All sums of money derived from the Commonwealth which are unexpended in any year in any school division shall revert to the fund of the Commonwealth from which they derived unless the Board of Education directs otherwise. All sums derived from local funds unexpended in any year shall remain a part of the funds of the governing body appropriating the funds for use the next year, but no local funds shall be subject to redivision outside of the locality in which they were raised.

LOCAL LAW

Portsmouth City Charter - Article VIII Section 8.01 School Board (repealed effective July 1, 2011)

The school board of the City of Portsmouth shall consist of nine (9) trustees who shall be appointed by the council from the city at large

Portsmouth City Charter - Article VIII section 8.02 School Funds (repealed effective July 1, 2011)

...

No money shall be paid out or become available to be paid out for any contemplated expenditure unless and until there has first been made an appropriation for such contemplated expenditure by the council.

Should any moneys, other than capital items, derived from sources other than state funds be unexpended in any year and thus become available for use the next year pursuant to 22.1-100 of the Code of Virginia, the council may provide in the budget that the city's share of the appropriation for the next ensuing year shall be decreased in a like amount.

**Portsmouth City Charter - Chapter 10 Public Education (enacted effective July 1, 2011)
Section 10.02 – School Board**

The school board shall be composed of nine members who shall be elected at large for terms of four years in the manner prescribed by general law.

Portsmouth City Council Resolution of June 12, 2001

Whereas, any unspent operating fund balances of the School Division revert to the City at the conclusion of each fiscal year,...

1. Any unspent operating fund balances of the School Division will, upon receipt of a written report of the School Board designating specific School capital projects, be re-

- appropriated in accordance with paragraph 2 for the specific projects requested or such other projects as Council may deem appropriate; and
2. That, in order to increase the City's undesignated General Fund Balance which supports all City and School functions, Council will retain 25% of any such unspent operating fund balance, thus returning a net of 75% of such funds to the School Division...

FINDINGS AND CONCLUSIONS

I. THE PORTSMOUTH SCHOOL BOARD DID NOT EXPEND MONEY IN EXCESS OF THEIR AVAILABLE FUNDS, NOR WERE ANY FUNDS UNACCOUNTED FOR

The issues addressed by the Special Grand Jury pertain to whether the School Board and its Superintendent properly reallocated the money that was appropriated to them and whether all necessary unexpended funds were returned to the City at the close of each fiscal year. There has never been any allegation that the School Board has spent more money than had been available to them. Although under Virginia Code §22.1-91, it is criminal malfeasance for any school board, school board member or school superintendent to spend (or contract or vote to spend) more money than it has available, this Special Grand Jury saw no indication that suggested the School Board had spent beyond their available funding. To the contrary, the School Board has always operated financially within those limits. All funds were properly accounted for and used for school purposes. Therefore, the Special Grand Jury does not find any evidence to warrant criminal charges against any school officials for malfeasance.

II. BY APPROPRIATING FUNDS TO THE SCHOOL BOARD BY LUMP SUM, CITY COUNCIL ALLOWED THE SCHOOL BOARD TO DIVERT MONEY AND EXPEND FUNDS ON OTHER THAN THEIR ORIGINAL PURPOSE

The Portsmouth School Board receives funds from federal, state and local sources. The testimony before this Special Grand Jury revealed that as the economy declined so did the amount of school funding at the federal, state and local levels. The state previously required a

certain portion of funds received from the lottery be designated for capital improvements. When the state removed that requirement, the funding for those capital improvements was also reduced. Bonds had also previously been issued to fund capital improvements, but no new bond funds would be available for several years. Additionally, student enrollment declined which meant lower non-local funding, as state and federal funds are tied to student enrollment. When the School Board was advised that there would be a decrease in funding for capital repairs and construction at both the state and local levels, they began to look for ways to save money to fill this gap. One significant means by which they did this was through attrition of non-teaching staff, as well as some attrition of teaching staff and combining of classes due to declining enrollment, since employee salaries and benefits constituted a substantial part of the overall school budget.

Although pursuant to Virginia Code §22.1-89, the School Board is responsible for managing and controlling its funds, under Virginia Code §22.1-94, the local governing body (i.e. City Council) may appropriate money to the School Board either as one lump sum or by the major classifications listed in Virginia Code §22.1-115. **IF** City Council elects to appropriate money to the School Board by those major classifications, the School Board may only expend funds received in accordance within those classifications. It is immaterial whether in making its annual budget requests to City Council the School Board did so by category in order to explain or justify its financial needs. What is controlling is whether the appropriation was made by City Council to the School Board as a lump sum or by major classification. The major classifications appropriation was not done by Portsmouth City Council, which enabled the School Board to redirect funds from the General Fund to the School Construction Fund without either the consent or knowledge of the governing body. The School Board and its Superintendent were therefore

able to develop a scheme by which they could build funds in the School Construction Fund which they otherwise would not have had available for use.

It should also be noted that until its repeal effective July 1, 2011 the Portsmouth City Charter provided that no money could be paid out for any contemplated expenditure by the School Board unless and until there was first made an appropriation for that expenditure by City Council. This provision was inapplicable for two reasons. First, that provision in the Charter was part of a larger statutory scheme for the authority and conduct of the School Board when it was an appointed body. With the creation of an elected School Board in 1996, the remaining portions of the Charter based on the appointment of members should be considered void as well. Second, and more importantly, because City Council elected to appropriate funds in one lump sum versus by major category, no additional specific appropriation for any specific expenditure was necessary.

III. THE AMOUNT OF SURPLUS FUNDS WAS DISPUTED IN THE TESTIMONY

The newly appointed CFO, Carol Swindell, states that during the five year period of fiscal year 2006/2007 through 2010/2011 the total was slightly over \$52 million, of which nearly \$41 million was transferred to the School Construction Fund, and the remainder to the Grants Fund and other accounts. Yearly amounts transferred ranged from \$8 million to over \$12 million, or from 5% to slightly over 9% of the total budget. It was the amount transferred to the School Construction Fund that caused the most concern. Ms. Swindell found this unusual in that it had been her experience in other areas that large capital improvements were typically funded through the governing body's (i.e. City Council's) capital improvement budget. However, the testimony of others claimed that because funding from other sources had been significantly reduced, the School Board was forced to find other means or forgo needed repairs and

construction. Testimony from personnel involved in the process during the time frame in question also was that at least \$23 million of that total was transferred as a result of matching fund requirements of certain state and federal appropriations and that those funds were in fact expended. Large portions were also dedicated to the S.H. Clarke renovation, which the School Board was required to finance due to declining funds from other sources, and other projects.

A detailed analysis of how savings were realized (that is, an accounting of the total amount transferred and which expenses were less than budgeted in order to provide additional funds for repairs and construction) and the appropriateness of those financial decisions is beyond the scope of this inquiry, as under current law they were decisions that were within the School Board's authority.

It is this Special Grand Jury's opinion that should the City Council feel it is in the City's best interest to appropriate funds to the School Board by major classification and thereby require the School Board to expend funds as classified and seek approval to deviate from the initial budget in a more public setting they are free to do so. Under such circumstances the School Board would be required to seek the approval of City Council before moving funds from one classification to another, but would retain the right to move funds within a given classification in accordance with their needs and resources.

Regardless of the amount of funds that were reallocated, without a law prohibiting the movement of funds within or outside a category, the School Board moved funds from one category to another without any oversight or public input. By creating funds from attrition to be placed in the School Construction Fund without City Council approval, the School Board was allowed to funnel funds from those devoted to our most important asset – the educators of our children – to facility maintenance, repairs and construction. Additionally, the actions of City

Council in choosing to appropriate funds by lump sum allowed the members of City Council to relieve themselves of direct responsibility towards insuring that the funds they provided to the Schools were spent as intended, and shielded the School Board from any public scrutiny on the issue.

IV. THE PORTSMOUTH SCHOOL BOARD FAILED TO RETURN SURPLUS FUNDS TO THE CITY. THIS FAILURE WAS KNOWN TO KEY ADMINISTRATIVE OFFICIALS OF THE CITY YEARS BEFORE THE APRIL 24, 2012 PRESENTATION BY MS. SWINDELL, AND SHOULD HAVE BEEN KNOWN TO OTHERS

State law (Va. Code §22.1-100) provides that any local funds received by the School Board that are “unexpended” at the end of the fiscal year are funds of the governing body (i.e. City Council). Until July 1, 2012, the Portsmouth City Charter provided that unexpended School Board funds became available for use per that same state code section, and therefore revert to the City. Although the applicability of the City Charter as it pertains to funds appropriated to the School Board is questionable following the institution of an elected School Board system, this provision of the City Charter as written then was in line with the State Code. Finally, by Resolution adopted June 12, 2001, any “unexpended” funds were required to be returned to the City. If the School Board provided therewith a request for funding for a specific capital project, 75% of the returned funds would be appropriated back to the School Board by City Council and 25% retained by the City.

It is clear from the evidence presented that several administrative officials of the City, including the former City Manager and several previous Chief Financial Officers were aware that the School Board was cutting expenditures from the General Fund to generate surplus funds to transfer to the School Construction Fund for capital improvements in the future. The testimony disclosed more than one conversation regarding the matter, and the information was

contained in the Combined Annual Financial Report (CAFR) for each fiscal year. Yet no action was taken and there was no evidence that the City ever made any requests to the School Board or its Superintendent for the return of the surplus funds under the 75/25 resolution.

The School Board and its Superintendent have taken the position that there were never any significant surplus or unexpended funds to return to the City under the 75/25 resolution because all major amounts of excess funds had been encumbered. "Encumbered" is an accounting term referring to those funds that can be set aside to cover future expenditures for which there is a legal obligation to pay. This Special Grand Jury specifically finds that a large portion of funds the School Board claimed were encumbered were in fact not encumbered to the extent claimed, and therefore those funds were required to be returned to the City under the 75/25 resolution.

As indicated above, CFO Swindell concluded that during the five year period of fiscal year 2006/2007 through 2010/2011 slightly over \$52 million of school board funds were transferred to other accounts, of which nearly \$41 million was transferred to the School Construction Fund. Her reading of the documents available led her to conclude that these funds had not been expended by the end of the fiscal year, and therefore were required to be returned to the City as "unexpended" funds that could not be spent by the School Board without reappropriation. Intentional or not, when these findings were presented to the City Council in April 24, 2012, those in attendance were left with the clear belief that the School Board had been "hoarding" money and had amassed \$52 million that was still being held and had not been spent or returned to the City. In her testimony before this body, she clarified that she had not received documentation to confirm whether the transferred funds had been spent and, if so, on what, but that it appeared that during the same time period that approximately \$41 million was transferred to the School Construction Fund, almost \$34 million was properly expended through that fund.

Review of the Comprehensive Annual Financial Report (CAFR) for fiscal year 2007/2008 revealed the School Board listed an excess of revenues over expenditures in the General Fund of \$7,296,159. This was characterized by Ms. Swindell as a "surplus" in her presentation to City Council on April 24, 2012 and in her testimony before this Special Grand Jury. The majority of that amount was transferred to the School Construction Fund (\$6,418,956) and the remainder to the School Grants Fund (\$877,203). It is widely accepted that the transfer of money to the School Grants Fund is required by law, and therefore not subject to being returned to the governing body (i.e. City Council) at the close of the fiscal year. However, the school also listed an end of year balance of \$12,405,294 in the School Construction Fund of which \$9,527,957 was designated as "reserved capital projects" and \$2,877,337 was classified as "unreserved capital projects". "Reserved" fund balances are those that have been legally segregated for a specific purpose or do not represent available expendable resources. "Unreserved" funds represent the remainder of the funds which could not be classified as both unexpended and encumbered.

It is at least the "unreserved" funds which this Special Grand Jury believes the School Board was obligated to return to the City at the end of each fiscal year. They were clearly "unexpended" as referred to in Virginia Code §22.1-100, the City Charter and the 2001 City Council Resolution. While that Resolution would provide for returning 75% of those funds to the School Board for a specific capital project (or more should a further Resolution provide for a different amount) the failure of the School Board to return those funds to the City with a request for reappropriation violated both the state statutory scheme and local legal requirements. Although these violations are not defined as criminal in nature, they allowed the School Board to

circumvent the proper appropriation procedures which allow the City Council to carefully consider the advisability and feasibility of proposed capital projects in a public forum.

Of all the evidence received by this Special Grand Jury, two pieces of evidence suggest a conscious decision by the Superintendent of Schools, David Stuckwisch, to circumvent the budget process with regard to the School Construction Fund. First, Director of Finance for the Portsmouth School Board, Meera Phaltanker, testified to what became known as the "Stuckwisch Initiative", which was a calculated plan to carve out funds from the School Board's General Fund largely via attrition and divert them to the School Construction Fund in order to fund capital improvements for which City Council declined to appropriate money through the normal budget process. Second, Superintendent Stuckwisch demonstrated the nature of the initiative in his presentation at the Joint Work Session on May 7, 2012.

While the CAFRs are admittedly lengthy and complex reports which require close scrutiny to completely comprehend, it is the obligation of our elected officials to do just that. As appropriations to the School Board constitute one of the largest single expenditures of city funds, the duty to ensure that those funds are being handled as required by law is a responsibility the City Council has to the public at large and the students, parents and employees of the schools in particular. This Special Grand Jury finds City Council's failure to be aware of the fact that these unexpended funds, particularly those which were unencumbered, existed at the end of each fiscal year dating back to at least as early as 2007 to be irresponsible.

As noted above, the total amount of funds in excess of expenditures the School Board transferred to the School Construction Fund at the end of fiscal year 2007-2008 was \$6,418,956. The end of year balance of unreserved funds was \$2,877,337. It is that amount which should have reverted to the City.

For fiscal year 2008-2009 the total amount of funds in excess of expenditures the School Board transferred to the School Construction Fund was \$10,816,024. The end of year balance of unreserved funds designated for capital improvements was \$10,893,729. It is that amount which should have reverted to the City.

For fiscal year 2009-2010 the total amount of funds in excess of expenditures the School Board transferred to the School Construction Fund was \$7,356,264. However, there were no unreserved funds at the close of the fiscal year.

For fiscal year 2010-2011 the total amount of funds in excess of expenditures the School Board transferred to the School Construction Fund was \$11,091,937. The end of year balance of unreserved (now called unassigned) funds was \$9,943,797. This amount was recently returned to the City as required with a request for reappropriation, which request was approved in part by City Council.

While this Special Grand Jury remains optimistic that this recent action represents recognition by the School Board, its Superintendent and City Council of their obligations as well as a new found understanding of the proper accounting and legal requirements regarding excess funds, additional safeguards as detailed below should be instituted to insure continued adherence to these principles.

CONCLUSIONS & RECOMMENDATIONS

1. Based on the evidence presented to the Special Grand Jury, no criminal statutes have been violated. Therefore, the Special Grand Jury directs the Commonwealth's Attorney not to file criminal indictments against any person or body politic.
2. The Special Grand Jury unanimously recommends the following changes be made by Portsmouth City Council when funding the Portsmouth School Board:

- a. Appropriation of funds to the Portsmouth School Board by Portsmouth City Council should be accomplished by adopting Section 22.1-115 of the Code of Virginia, 1950 as amended as the method by which funds are allocated for use by the Portsmouth School System. That is, funding to the School Board should be by category and not by lump sum.
 - b. Portsmouth City Council should conduct quarterly reviews of School Board financial records to stay apprised of the year to date expenditures and available resources.
3. The Special Grand Jury unanimously recommends that the Portsmouth School Board and School Administration insure compliance with the letter and spirit of the laws and regulations regarding the returning of all unexpended funds at the close of each fiscal year.